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TechNotes # 5

SBIC TechNotes

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CREDIT MANAGEMENT PROCEDURES

The purpose of this TechNote is to provide information with respect to certain procedures within the Office of Investment which affect the availability of SBA leverage and the management of SBA's risk as a creditor or as a preferred limited partner in certain SBICs. Any questions regarding these practices may be addressed to the appropriate party within the Office of SBIC Operations (the Director, or the appropriate Area Chief or Financial Analyst), or to the Chief of Licensing.

CONDITIONS FOR FIRST TAKEDOWN OF SBA LEVERAGE

Commitments for the funding of leverage are issued pursuant to 13 CFR 107.1200 through 107.1240. Normally, commitments will be offered only twice a year (May and November). Licensees should note these dates in their annual plans in order to prepare for them. New licensees do not need to wait until the next period of commitment availability, but will be given the opportunity to purchase leverage commitments for up to two tiers of Regulatory Capital at the time of licensing. In order to reduce the number of transactions and to save processing time, licensees are asked to submit commitment requests for a minimum of 25% of Regulatory Capital.

All licensees must obtain a commitment in order to draw leverage, regardless of the type of leverage utilized. Commitments expire on September 30 of the fourth full federal fiscal year following issuance and require the payment of a fee equal to 1 percent of the total commitment at the time of issuance. An additional fee equal to 2 percent of the amount drawn is deducted from each disbursement of funds to the licensee.

For newly licensed companies, SBA will not approve commitments until the company has submitted an opening SBA Form 468. In addition, in order to be eligible for its first draw on a commitment, the newly licensed SBIC must have invested at least 50 percent of its Leverageable Capital. Generally not more than one half tier (50%) of Regulatory Capital can be drawn for new licensees until there has been some investment activity and an examination to review that activity. Successor funds with management teams successful in the SBIC program will not be subject to this limitation.

LIMITS ON DEBENTURE LEVERAGE FOR EQUITY INVESTORS

Recently, most SBICs intending to invest in equity-type securities have chosen to be licensed as participating securities issuers, and some licensees with equity-oriented portfolios have converted from debentures to participating securities. However, there are still a number of debenture issuers investing predominantly in equity-type securities, despite their initial intentions and the business plans submitted in the licensing process. Equity-type securities are non-current-pay investments, including true equity securities like common and preferred stock, and also subordinated debentures on which interest is payable only out of earnings.

SBA is providing guidance below for those licensees that are seeking debenture leverage and that also have a significant amount of equity-type securities in their portfolios. While unique conditions may warrant an individualized approach, SBA currently considers the following concepts appropriate as general guidance:

- Debenture issuers are not discouraged from making investments in equity-type securities. However, the current and prospective debt service requirements which would result from approving additional debenture leverage should be covered by the licensee's operating income.
- If a debenture issuer has no remaining undrawn Regulatory Capital and has a substantial shortfall between

operating income and prospective debt service, it should not expect SBA to issue a commitment for additional debenture leverage.

- Because of the uncertainty of both timing and amounts, proceeds from anticipated sales of portfolio securities cannot be relied upon as the primary or sole source for covering debenture debt service. SBA will not assume that prior success in meeting debenture debt service payments from successful portfolio exits predicts future success in doing so.
- Decisions on granting additional commitments will be based on prospective total debt service assuming all potential committed leverage is outstanding.
- Commitments for up to two tiers of debenture leverage will be considered for a predominantly (greater than 50%) equity portfolio, as long as the portfolio has enough "current pay" securities to cover the debt service. If the existing portfolio cannot demonstrate sufficient "current pay" investments, commitments for debenture leverage will generally be limited to 1.5 tiers of Regulatory Capital.
- A major change in the portfolio mix from the original business plan or a recently submitted plan may be cause for declining additional debenture leverage.
- Conversion to a Participating Securities SBIC will be considered if the licensee has the required \$10 million of Regulatory Capital, the portfolio is expected to have enough qualifying Equity Capital Investments, management has demonstrated a successful track record of investing in equities, and the private limited partners agree to this change in investment direction and the additional licensing steps required to convert.
- A participating securities issuer seeking additional leverage in the form of debentures must demonstrate that "current pay" investments are in accordance with its business plan

THIRD PARTY DEBT

SBA regulations provide for the conditions under which SBA approval of secured third party debt may be requested by an SBIC. These regulations were last revised in 1996, and they were in response to conditions at the time. Specifically, the SBIC program had experienced periods when the amount of leverage fell short of demand. Also, the program at that time had offered leverage fundings only once per quarter and no leverage commitment program was in place. If a licensee missed a quarterly funding it would have to wait approximately 90 days to obtain additional SBA leverage, assuming there was enough available to satisfy the demand. Under these circumstances, third party debt was not only appropriate but advisable in order to meet investment and liquidity requirements.

With the arrival of five-year leverage commitments, Just-In-Time funding, and adequate levels of program leverage, SBA believes there is no longer a need for third party debt in most situations. In fact, there is very little usage of third party debt in the SBIC program at the present time by current licensees.

While SBA is not requiring existing secured third party debt facilities to be cancelled, we are not approving most new secured credit facilities. With respect to license applicants, several have requested secured facilities to fund a high level of pre-licensing investments and to avoid a series of private investor capital calls during the licensing period. SBA has approved such temporary facilities under the following conditions:

1. SBA has been provided with a copy of the proposed credit agreement.
2. The terms of the third party credit facility require that it be repaid with the first draw of leverage and that the facility is then automatically cancelled.
3. The SBIC has not granted a blanket lien on all of the SBIC's assets.
4. The SBIC has \$2.5 million in cash or eligible investments, unencumbered by a security interest or pledge of any type. If so, the credit facility may be secured by security interests in the specific investments funded by draws under the credit facility and/or by the assignment of unfunded private investor capital commitments.
5. Any security interest in the investments and any assignment of unfunded commitments must terminate upon repayment

of the facility with the first leverage draw.

WIND-UP ARRANGEMENTS FOR LIMITED LIFE SBICs ISSUING DEBENTURES

In the past, most debenture-issuing SBICs were corporations, and no particular planning was required for the wind up of their operations. Today, leveraged SBICs are increasingly choosing a limited life structure, with many debenture issuers choosing to organize as limited partnerships or, occasionally, as limited liability companies.

In SBA's experience, limited life SBICs often exhibit a pattern of operations as they mature. Typically, by year 6 of a 10 year limited life SBIC, all of the private capital has been drawn, no new investments are undertaken, investment activity is limited to add-on investments to existing portfolio positions, and the primary focus is on exiting the portfolio and winding up the SBIC. Limited life SBICs that issue SBA-guaranteed debentures, which are non-amortizing, are likely to enter the wind up phase of their lives with debentures still outstanding.

The only regulation that expressly addresses the wind up phase of an SBIC's life is 13 CFR 107.590, the activity requirement for SBICs. Other relevant provisions in SBA regulations are the optional return of capital provisions of 13 CFR 107.585, and the definition of Retained Earnings Available for Distribution in 13 CFR 107.50. However, limited life SBICs that issue debentures pose a different set of issues involving SBA's ability to protect its financial interests during the wind up of operations.

To address these issues, SBA has developed the following guidelines for the wind up phase of limited life debenture SBICs:

1. In accordance with 13 CFR 107.585, a distribution that would reduce Regulatory Capital by more than 2% in any fiscal year requires SBA's prior written approval. Such approval will only be considered as a part of a comprehensive wind up plan approved by SBA.
2. At the point when an SBIC is no longer making new investments, SBA encourages the licensee to submit its version of a wind up plan. We will review the plan and determine if it adequately protects SBA's position as creditor. SBA regulations at 13 CFR 107.590(c) provide general guidance for such plans.
3. In any windup plan submitted, plans for the repayment of SBA leverage should identify specific sources of funds (either realized sales of identified securities or segregation of funds for that purpose).
4. An integral part of any wind up arrangement is an agreed-upon plan showing pro forma distributions over the expected remaining life of the SBIC. This has been the case in all recently approved wind up plans.
 - A. The plan must show repayment of all SBA leverage prior to the private capital being returned in its entirety.
 - B. Sources of cash flow and related estimates of timing must be identified in the plan.
 - C. In the event of substantial deviations from the plan (say, annual cash flow being more than 10% off) previously agreed-upon distribution arrangements may be suspended.
5. At the beginning of Year 6 of a limited life debenture issuer, the financial analyst will normally request that the licensee submit an "end game" scenario with respect to its remaining life. This would generally be in the form of a narrative summary covering remaining liquidity events, amounts, and timing as well as general follow-on investment intentions.
6. Any leverage which is to be advanced during a wind up will be governed by the following principles:
 - A. The leverage should only be for add-ons to existing portfolio investments or to cover operating expenses. No new financings should be undertaken.
 - B. The expected duration of the investment made with the leverage proceeds should be within the remaining wind up period.
 - C. Specific exit strategies for each existing portfolio investment should be identified.
7. In reviewing requests for leverage during a wind up period, the Credit Committee will consider the advisability of

requiring either a provision for the buildup of a liquidity reserve, (including an agreement to forego maximum distributions otherwise available from READ), or the commitment on the part of the licensee to prepay SBA debentures at the earliest practicable date.

8. All wind up plans will be reviewed and, if necessary, negotiated by the Area Chief and SBA analyst responsible. In the event of particularly complex cases or in the event of substantial disagreement between such individuals and the SBIC, wind up plans may be reviewed by the Credit Committee.

MAXIMUM LEVERAGE TO RELATED SBICs

Several licensees have inquired about whether SBA will consider exceptions to the leverage ceiling for groups of related licensees, as described in 13 CFR 107.1150. The ceiling establishes the maximum amount of leverage that a licensee or group of licensees under common control can have outstanding at any one time. It is adjusted annually to reflect September-to-September increases in the consumer price index. Based on price changes for the year ended September 30, 2000, the ceiling is now \$108.8 million.

SBA's view is that outstanding leverage in excess of the ceiling will tend to concentrate SBA leverage (and the associated risks) in fewer hands. While SBA is prepared to extend leverage commitments to related SBICs in excess of the current ceiling, SBA has not yet been convinced that related SBICs should be permitted to have outstanding aggregate leverage in excess of the ceiling.

PLACEMENT OF AN SBIC ON THE WATCH LIST

The Office of SBIC Operations prepares a monthly Watch List Report. This report follows the progress of licensees that merit additional scrutiny for financial, regulatory, or other reasons.

Monitoring the financial performance of an SBIC is an oversight responsibility. One important indicator of financial condition in the SBIC program is a licensee's capital impairment percentage, as determined under 13 CFR 107.1830 - 107.1850. An SBIC will be placed on the Watch List when its capital impairment (as reported by the SBIC or as adjusted by SBA, whichever is higher) reaches 65% of the maximum permissible rate specified in 13 CFR 107.1830(c).

With respect to Participating Securities issuers, SBA also considers the effect of accumulated prioritized payments in evaluating financial condition. While prioritized payments are not a liability of the SBIC until profits are available to pay them, they represent an out of pocket cost to SBA and an ultimate loss if not reimbursed by the SBIC. Therefore, the total measure of SBA's financial exposure is best represented by the following adjusted impairment computation:

$$\frac{\text{Realized Losses} + \text{Net Unrealized Depreciation} + \text{Accumulated Prioritized Payments}}{\text{Regulatory Capital}}$$

Participating Securities issuers may be placed on the Watch List if the recalculated impairment is at least 50% of the maximum allowable impairment percentage applicable to the SBIC (in accordance with 13 CFR 107.1830 or 107.1850, as appropriate).

SBA may also place an SBIC on the watch list for other than financial reasons. For example, serious regulatory violations may be a cause for placement of the SBIC on the watch list.

If placed on the watch list, an SBIC will be asked to provide quarterly (or more frequent) financial statements to SBA, along with a plan to cure the situation that caused the company to be placed on the watch list.

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